STATEMENT OF

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ON INSURANCE REGULATION AND COMPETITION FOR THE 21ST CENTURY

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE

AND GOVERNMENT SPONSORED ENTERPRISES

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Introduction

Mr. Chairman, Ranking Member Kanjorski, and members of the Subcommittee, my name is Ann Spragens. I am Senior Vice President and General Counsel of the Alliance of American Insurers, an association of 335 insurance companies.

I am here today to express our strong conviction that the public policy objectives of insurance regulation can best be met by improving, not abandoning, the state system. Also, I have been asked to discuss how state regulation of insurance is funded, and how such funds are allocated to state regulatory functions.

Today, insurance companies, producers, consumers, and regulators face an array of economic and political conditions that compel a re-examination of the current system of state-based insurance regulation. These challenges include the emergence of new competitors and competing regulatory priorities associated with implementation of Gramm-Leach-Bliley, industry frustration with current regulatory practices and resulting inefficient and often redundant or inconsistent requirements, the competitive imperatives of e-commerce, and the economic pressures associated with market consolidation and increasing globalization.

Of these, the inefficiencies and delays in state regulatory processes - as much as the outdated model of state regulation - bear most of the blame for the unacceptable condition of insurance regulation today. The status quo is being rejected by virtually every stakeholder, including insurers, producers, consumers, and many regulators. Without timely and significant reform, state insurance regulation will be at risk of becoming an anachronism.

While some in our industry and the Congress have called for federal regulation or an optional federal charter, the Alliance believes that the goals of insurance regulation - to assure consumers that the promises made to them will be kept, that insurance will be sold at a fair price, and that the company they bought from remains financially strong - can best be met by improving, not abandoning, the state system.

Funding of State Insurance Regulation

I would like to spend a few moments addressing your questions regarding how state insurance regulation is currently funded. Insurance departments raise revenue for their states through various licensing, filing and examination fees received from insurers and insurance producers. These fees are substantially augmented by the states' collection of premium taxes, generally one to two percent of the prior year's written premium. Some variance exists across the states as to how these funds are allocated to insurance regulatory functions. In most states, fees and taxes flow into general revenue for subsequent legislative appropriation to the insurance department budget. A number of states have implemented dedicated funding whereby fees collected flow to an account dedicated to the department's budget supplemented by the annual appropriation process.

In the 1999 Insurance Department Resources Report, published by the National Association of Insurance Commissioners (NAIC), aggregate budget dollars made available to insurance regulators totaled approximately $839 million in 1999 to cover in excess of 10,000 employees and some 1400 contract examiners and consultants. These figures have increased in recent years as states have enhanced certain regulatory functions, especially in the areas of solvency regulation and computerization, but have begun to level off. As one would expect, the cost of regulation varies from state to state based upon the relative size of the state's insurance market, its population and demographics, and the number of domestic insurers. For example, in 1999, California had 1,243 employees and a budget in excess of $129 million, while Wyoming retained a staff of 25 on a budget of $1.3 million. The large market states of California, Illinois, Florida, New York and Texas employ similarly large professional staffs to carry out regulatory functions.

State insurance regulators have the necessary resources to regulate effectively. However, the question is not only one of sufficient budget dollars. Whatever the regulatory model, the real issues revolve around the appropriate and efficient allocation of regulatory resources to those functions that truly effectuate the goals of insurance regulation. Budget comparisons between state insurance regulators and the other functional regulators of financial services at the federal level are less than meaningful. They regulate different industries - subject to different market dynamics and different laws - with a substantially different mix of regulatory objectives and functions.

Improved State-based System of Regulation

As noted earlier, some in our industry and the Congress have called for federal regulation or an optional federal charter. The member companies of the Alliance believe the goals of property and casualty insurance regulation - to assure consumers that the promises made to them will be kept, that insurance will be sold at a fair price, and that the company they bought from remains financially strong - can best be met by improving, not abandoning, the state system. Let me explain why.

State regulation of insurance is a product of our federal system of governance. Federalism reserves to the states powers not expressly granted to the central government – and for good reason. As the Founding Fathers believed in 1787, the sovereignty of the states, especially in the areas of civil and criminal law and the administration of the courts, would become a bedrock principle for our country, even as we enter the 21st century.

The states have a constitutional prerogative to establish liability systems and similar laws to promote social responsibility. Since property and casualty insurance is so closely associated with the tort and contract laws of the states, it follows that insurance regulation should remain state-based. For example, liability laws affecting automobile reparations, workers compensation, property damage, and personal injury differ from state to state, reflecting diverse public attitudes about responsibility and compensation. Insurance products are designed and priced differently in each state to account for these differences. At its best, state insurance regulation is adaptable to changing notions of public policy or to competitive pressures of the industry.

The best characteristics of the state system, including diversity, innovation, and responsiveness, would be lost in a federal or national model of insurance regulation. Federal or national models imply a single uniform set of rules applying equally across all states and all insurance markets. It is difficult to imagine a single regulatory system working in harmony with the diversity of underlying state reparation laws and differing public expectations about the role of insurance regulation. For example, will an open and competitive rating law work in a state with a tradition of subsidizing urban drivers? How responsive would federal regulation be to market dislocations in individual states caused by unique weather patterns or unusual interpretations of law? Can market conduct be fairly assessed by a federal regulator unfamiliar with the underlying state property and insurance laws?

That the states are better positioned than the federal government to accommodate diversity or to respond to change is not a full defense, however, to the charge that insurance regulation has failed in recent years to adapt to changes in the industry and the markets it serves. Significant weaknesses exist in state regulation today. Unnecessary distinctions among the states and inconsistency within states - in the areas of company admissions and agent licensing, for example - reduce predictability and add costs. Similarly, outdated rules and practices, particularly those that interfere with the product design and pricing, do not serve the goals of regulation in a modern financial services market.

What is needed is a new regulatory model - one that builds on the states' inherent strengths to meet the challenges of rapidly changing insurance environment. The new regulatory model must respond, for example, to the reality of e-commerce. Regulation that impedes this will force customers out of insurance markets to other financial services providers. Consolidation and globalization are forcing companies and their regulators to take a more integrated view of holding company regulation that is neither protectionist from the perspective of foreign carriers nor an impediment to domestic carriers to grow and more favorably compete in world markets. Constrained by outdated regulations, traditional insurance markets and products are giving way to alternative markets. The new regulatory model must respond faster and more fully to these emerging trends.

Significant and immediate improvements to state insurance regulation, particularly in the areas of company licensing, financial regulation, corporate governance, and rate and form filing efficiency, can be made without extensive statutory changes. More fundamental change such as a shift away from a prior approval model to a competitive one relying on market based pricing and product design will require legislative action. Critical to the success of state regulatory reform is the recognition and adoption by the NAIC and by the individual states of a "best practices" model with clear accountabilities, and explicit and significant reliance on regulatory collaboration and comity, including shared resources and the use of a "lead state" regulator, when appropriate - all consistent with state sovereignty and the principles of federalism.

For example, financial analysis, mergers and acquisitions, holding company transactions are all areas where regulatory principles are well established and nearly uniform across the states. However, the filing and approval processes are often quite different and introduce unnecessary complexity, delay and cost. Reliance on the domestic regulator for financial analysis and for holding company transactions makes sense, as does the use of standard forms and procedures for change of control and similar matters.

For rate and form filing in prior approval states, a set of best practices, including standardized review elements and timeframes, should be utilized. Electronic filing should be expanded. The NAIC's System For Electronic Rate and Form Filing System (SERFF) is one system for e-filing. It should be enhanced to accommodate multi-state filings as well as single state submissions and provide a direct electronic interface for insurers to use to minimize rekeying and other obstacles to easy use. Multi-state filings offer particular opportunities for advances to harmonize filing requirements in an environment where regulatory collaboration in the form of multi-state review teams could simultaneously review a filing subject to common information requests and common timeframes for review and disposition. While e-filing holds promise for the expedited flow of information, without improvements to the review process itself or the relaxation of filing and approval requirements, SERFF alone will not sufficiently improve speed to market conditions.

We would expect all states to immediately begin moving away from prior approval regulation for insurance rates and forms, particularly for commercial lines. While we believe a competitive market is the best regulator or product and price for all lines or insurance, we recognize that a modest level of rate and form regulation for personal lines may be perceived as desirable in some states. The Best Practices model should be expanded over time so that notions of competitive pricing and informational form filing are, themselves, elements of the model.

Important reforms of producer licensing laws are necessary and achievable, as they enjoy broad support from among producers, carriers, consumers and regulators. However, it is critical that uniform and commercially rational definitions of "sell, solicit or negotiate" continue to be adopted in the form of the NAIC Producer Licensing Regulation so that license requirements are not based on increasingly dated notions of how insurance products should be marketed.

The new regulatory model should rely less on front end regulation and more back end or market conduct regulation. Market conduct is an area that lends itself well to the emerging changes in insurance regulation. Adherence to best practices promotes efficient behaviors on the part of carriers and regulators and reduces the chance for error. To fairly and effectively measure carrier performance, market conduct examinations, themselves, should be subject to best practices protocols.

State insurance regulators, through the NAIC, are making significant progress on their reform agenda to modernize state insurance regulation. This agenda, for the most part, reflects the themes I have put forward today. However, it is critical that the reform debate now move to the state capitols where the insurance commissioners must lead the effort to redesign and modernize state insurance regulation.

Conclusion

Mr. Chairman, I appreciate the opportunity to appear before this Subcommittee today. I hope that my remarks illustrate to you how a modernized, state-based system of property and casualty insurance regulation can best address the challenges of today's insurance market in ways that result in a system that is genuinely improved, not merely preserved. This Subcommittee's efforts to explore these issues and to provide oversight of progress made on state reform initiatives will play a constructive role in moving the states to further action.

Thank you.